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There Is No Free Lunch

As I read about the anguish that is apparently being generated in many quarters by President Reagan's proposed cuts in the Federal budget, I wonder if people realize just where these funds come from. For all around the country, there are many people who seem to think that government money, particularly Federal government money, comes from some mysterious inexhaustible source. At least that's the way it seems to me, in view of the arguments they pose against cutting into their special interest programs. It's almost as though they think they have a "right" to tap the public well, since isn't that what it is there for?

I have what might be shocking news for these people, There are only two ways in which the Federal government can get money to spend. One way is to tax, the other is to borrow. Together they make up the true burden that the government imposes on the economy for they add up to total government spending. What these special interest groups would have us do in order to continue funding their various programs is to maintain — or possibly enlarge — the total burden of government on the economy in order that their particular interests be satisfied.

Special Interests Vs. The Nation's

Jimmy Carter put it quite appropriately in his farewell address to the Nation last January. "...We are increasingly drawn to single-issue groups and special-interest organizations to insure that, whatever else happens, our own personal views and our own private interests are protected. This is a disturbing factor in American political life. It tends to distort our purposes because the national interest is not always the sum of all our single or special interests." I would agree, and add: There is no such thing as a free lunch.

Scarcely a day goes by without one special interest group or another preparing to do battle over the Administration's proposed budget cuts. Indeed, a national coalition of trade unions, civil rights groups, religious organizations and social welfare agencies has already been established with the intent of protecting their members from the budget ax. The arguments their leaders use are compelling. They want to "fight against the unnecessary and unwise destruction of social and economic advances in the past 50 years," in the words of one prominent member. "Americans must tell the President and they must tell Congress that they will not sit still for this reactionary program," said another. "From poor to worse," observed the headlines of a major newspaper. The cuts would "drive more into the ranks of the truly needy," added another. And a prominent columnist took special pains to report that more than "300 social assistance programs — including food stamps, child nutrition, welfare, housing, unemployment benefits, jobs and training, education, scientific research, Medicaid and black lung, fuel-oil subsidies, legal aid for the poor, environmental protection, disaster and flood insurance, and veterans' benefits — " were earmarked for the budget ax.

The defense establishment is not acting any differently. Military personnel have rushed to Capitol Hill with their special requests over and above the hefty increase proposed by President Reagan. And, I might add, Jimmy Carter's defense budget for 1981 called for a sharp rise to begin with.

Three Options

All of this handwringing and beseeching looks toward Washington and cries that the Federal government should pour Federal money into various special interest programs means that these people want one of three things to happen. Either the Federal government should raise taxes in order to get the money to pay for these programs. Or Washington should borrow more from the private sector — raising interest rates in the process. Or Washington should borrow more from the Federal Reserve — raising prices, instead. There is no other way. There is no such thing as a free lunch.

Let us examine each of these particular "options" closely. Supreme Court Justice John Marshall once said that the power to tax involves the power to destroy. By that criterion we have done more dam-

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age to ourselves than any other foreign nation has done in a war. Our tax burden today stands at 32 per cent. That is — personal taxes of all kinds now account for 32 per cent of personal incomes. This is up 7.6 percentage points in 20 years.

This mounting tax burden has slowly but surely affected our ability to grow. In the past 10 years, the gross national product adjusted for inflation has expanded at a 3.6 per cent annual rate compared with 4.7 per cent in the previous decade. Recognizing this, President Reagan has proposed a program of sweeping tax cuts for individuals as well as businesses. While one might quibble with the exact timing of these tax cuts, in view of the sizable deficit that still exists in the Federal budget, there is no denying that the tax burden has to be lowered — and the sooner, the better.

That leaves government borrowing. Here the tab has risen even faster. In fiscal year 1980 Washington raised $119.1 billion to finance its on-and off- budget expenditures. This represented 35.7 per cent of total funds raised in the money and capital markets, and compares with 17.6 per cent just 10 years earlier. Not surprisingly, this increased presence in the financial markets by the Federal government was one of the reasons why interest rates were so high last year. In case you have forgotten, interest rates on six-month Treasury bills averaged 11.4 per cent in 1980: 10 years earlier these rates averaged 6.5 per cent and 10 years before that 3.2 per cent.

Of course, instead of borrowing from the private sector, Washington could always borrow from the Federal Reserve. Indeed, this has been the case more often than not. But borrowing from the Federal Reserve has the effect of creating money. And since Washington's budget deficit has been growing faster than the economy, the Federal Reserve has wound up creating money at a faster rate than our ability to produce real goods and services. When more money is in circulation than there are goods and services, it tends to lose value — in other words, we have inflation. And as readers of this Report should be well aware by now, inflation is our number one economic problem. This year we will very likely have another dose of double-digit inflation. That would make it three years in a row in which prices have gone up by ten per cent or more — a record not matched in half a century!

To be sure, the public at large would like to see a balanced budget. The only problem is — people have little enthusiasm for the cuts in Federal spending that would have to take place in order to get the budget in balance. This is not to say that people are not in favor of tightening belts. However, it always seems as though they want someone else's belt tightened, not theirs.

What It All Means

When people advocate that Washington should continue to pour Federal money into their special interest programs they are in effect saying that one of three things should come to pass. They are saying that the Federal government should continue the present rate of taxing of those who have in order to give to those who don't. Or they are saying that the Federal government should continue to borrow from the private sector to give to those who are unable to borrow on their own. Or they are saying that the Federal government should further erode the value of the dollar through more inflation in order to get funds to give to those who don't have.

There is no other way. There is no such thing as a free lunch.

The Problems Transcend The Federal Government

Although the precarious state of Federal government finances has preoccupied much of the attention of the financial press, it should not be allowed to overshadow some equally severe strains which continue to plague the private sector. The combination of high inflation rates and high interest rates continues to erode the financial strength of households and businesses, limiting their ability to expand spending and investment for any prolonged period of time. What is more, correcting the existing imbalances may well cause a pause in the pace of consumer and business spending later this year, limiting both the magnitude and duration of the anticipated rebound in the economy.

The likelihood of a downturn in consumer and business spending diminishes considerably, however, with the implementation of personal and business tax reductions. These cuts significantly enhance household and business liquidity, which would be required for stepped-up physical and financial asset acquisition and accelerated economic growth. But while bolstering near-term financial positions in the private sector, they may exacerbate the more fundamental problems that caused the deterioration in the first place—high rates of inflation and the massive Federal budget deficits that helped produce them.

Household Finances Need Improvement...

Much of the recent gain in retail sales was fueled by the strengthening of household finances which occurred earlier. However, these limited improvements in household balance sheets were probably not sufficient to support a sustained upturn in consumer spending this year. In fact, many of the improvements have already begun to reverse themselves, despite a still cautious consumer outlook. For example, although installment debt liquidations as a

percentage of disposable income currently stand well below their mid-1979 high, they have been rising modestly since last fall.

Another measure of household liquidity—the household debt service burden, which consists only of interest payments on both mortgage and installment debt service payments as a percentage of disposable income—has also been rising in recent months. It stood at eight per cent in the fourth quarter of 1980, the second highest level ever, and with interest rates remaining at lofty levels, could move even higher. Finally, the savings ratio has begun to drop once again. After climbing as high as 6.2 per cent in mid-1980 (expressed in relation to disposable income), it has since ratcheted downward sharply, falling to 4.4 per cent in January, 1981. This was a new record low and almost one-half of one per cent below month-earlier levels.

The correction of this renewed weakness in household finances may result in another period of sluggish consumer spending unless offset by a cut in taxes. Sizable personal income tax cuts would boost household cash flows substantially, stimulating spending and financial asset acquisition, and prompting good-sized increases in both growth rates and savings rates.

...As Do Corporate Finances

One of the areas of economic activity most vulnerable to the adverse effects of high inflation and high interest rates is business fixed investment. Weak balance sheets, high interest rates and unstable bond markets have tended to dampen externally-financed investment spending while sluggish profits growth has hampered internally-financed expenditures.

During the past year, for example, extensive short-term borrowings by U.S. business (reflecting in large part the lofty yields prevailing in the bond markets) led to a marked deterioration of corporate balance sheets. With commercial and industrial loans outstanding at large weekly reporting banks increasing by almost $20 billion during the twelve months ending December, 1980 (following a $23 billion gain during the same period in 1979), commercial paper issuance by nonfinancial corporations rising by almost $7 billion and short-term interest rates reaching historic highs both early and late in the year, it is hardly surprising that some key indicators of corporate financial health deteriorated. One measure of liquidity, the ratio of short-term to total liabilities jumped from 36 per cent in 1978 to 39 per cent by end-1980, a record high. The debt service burden also rose sharply during the period, with the percentage of gross internal funds required to service existing debt rising from approximately 26 per cent in 1978 to more than 40 per cent in the fourth quarter of 1980.

Corporate profits growth also remained sluggish. Although after-tax profits advanced 3.1 per cent in the fourth quarter, compared with quarter-earlier levels, they still stood 2.4 per cent below the comparable quarter a year ago and more than ten per cent below their first quarter peak. Much of the beneficial impact of an increased level of economic activity in the last quarter of 1980 was offset by a further escalation in the cost of doing business, especially sharp increases in labor, energy and financing costs.

Nor is the weakening of corporate financial positions expected to be reversed quickly. High interest rates will continue to swell debt service burdens to levels well above those prevailing at comparable stages of previous economic cycles. High inflation rates will continue to generate bouts of extreme instability in the bond markets, hindering complete recovery in the relative term structure of corporate liabilities. Finally, business profits growth will remain subdued, reflecting the sluggish pace of real economic growth, while, at the same time being eroded by high inflation and high interest rates.

And while the cash flow bolstering effects of substantial business tax cuts will provide a sharp boost to corporate liquidity, it alone will not correct existing problems. In fact, the impact of such reductions may be largely offset by higher inventory replacement costs and the upturn in capital spending expected during the latter half of 1981 and 1982. But at least such cuts will provide some additional resources to business to increase capital spending without additional recourse to external finance or further impinging upon existing internally-generated funds. However, with long-term borrowing costs still lofty and the bond markets still volatile, business firms will continue to rely on expensive, short- and medium-term financing for a substantial proportion of their borrowing requirements. As a result, the complete restoration of corporate liquidity positions will again be deferred.

In summary, strains developing, and already existing, within the household and corporate sectors of the economy could limit the strength and duration of the economic rebound. In each instance, the ability of consumers and business to sustain real spending levels has been eroded by a prolonged period of high rates of inflation and the resulting high interest rates. Although the tax cut proposals of the Reagan Administration will go a long way toward enhancing the spending and investing capabilities of households and business, their stimulative impact will only be short-lived unless more fundamental solutions to the existing economic problems appear on the horizon. The requirements: Increased investment and enhanced productivity economy-wide—the attendant benefits of a prolonged period of fiscal and monetary policy restraint on the part of the public authorities.

—Marc M. Goloven, Vice President

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